Martin Wolf: China must move to a flexible currency

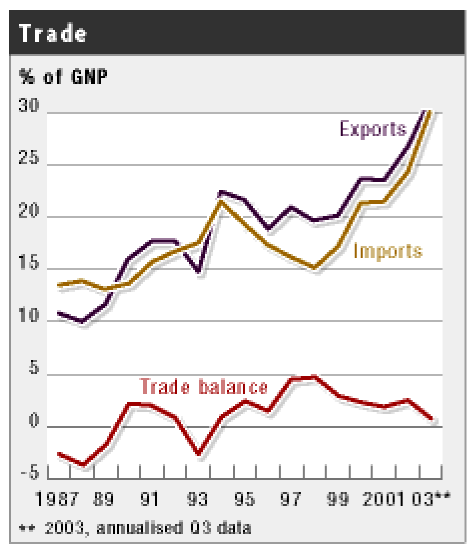
By Martin Wolf

Published: December 2 2003 20:29 | Last Updated: December 2 2003 20:29

To float or not to float, that is the question. To be more precise, it is one of the questions. The Chinese authorities could also repeg the renminbi at a higher rate. My recent visit has convinced me that the leadership will not change what they see as a successful regime in the near future. But it will also not last forever. When and how might it change?

Since the Chinese seem willing to accumulate foreign currency reserves without limit, the leverage of its partners is limited. This is a decision China will make, on its own terms. Nevertheless, the starting point must be whether the currency is undervalued. Many Americans assume it is, pointing to their country's vast, and growing, bilateral trade deficits. But these tell us nothing. What matters is the overall balance of payments.

Over the past seven years, China has been running current account surpluses of about $10bn to $40bn a year (see chart). The International Monetary Fund forecasts the surplus this year at $25bn, a little under 2 per cent of gross domestic product.* But China also has a huge net inflow of foreign direct investment. If one takes the sum of these two elements, the surplus this year will be a good 5 per cent of GDP.

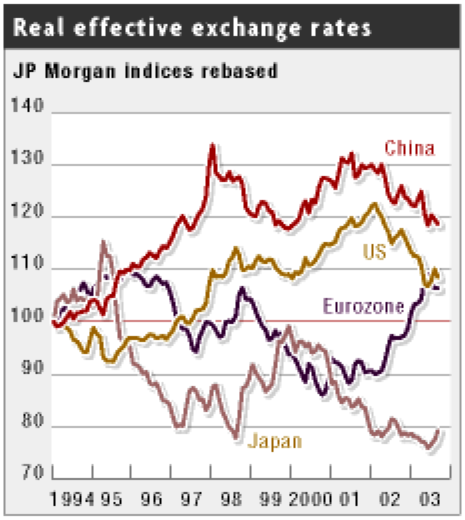


Until 2001, however, China also had a balancing outflow in the rest of its capital account. Overall, therefore, the country did not accumulate substantial foreign currency reserves. But this has changed. The balancing capital outflow has become a huge inflow. Between the end of 2000 and September 2003, foreign currency reserves rose by $218bn.

At least until 2001, surpluses on the current account and FDI were offset by other capital outflows. The currency was not undervalued. Strong upward pressure has emerged since then, but much of this may be speculative. On balance, the IMF's board of directors has concluded "that there is no clear evidence that the renminbi is substantially undervalued".

Nevertheless, two offsetting points must be made. The first is that global payments are significantly out of balance, with a huge US current account deficit offset by surpluses elsewhere. A real appreciation of the renminbi must be a necessary element in global adjustment. The second point is that the prices of China's exports are falling, in dollars. If many of the world's currencies appreciate against the dollar (and so also the renminbi), prices of a wide range of manufactures must fall in their domestic currencies. That would strengthen the charge that China is exporting deflation. It would be better if, instead, the dollar prices of China's exports were rising.

My conclusion is that the case for an appreciation of the Chinese real exchange rate has merit, from a global perspective. But the argument looks very different to the Chinese themselves. For them, the dollar peg has many advantages: it provides stability for both exporters and Hong Kong, whose currency is also pegged to the dollar; and it has given a framework in which the economy has performed excellently.

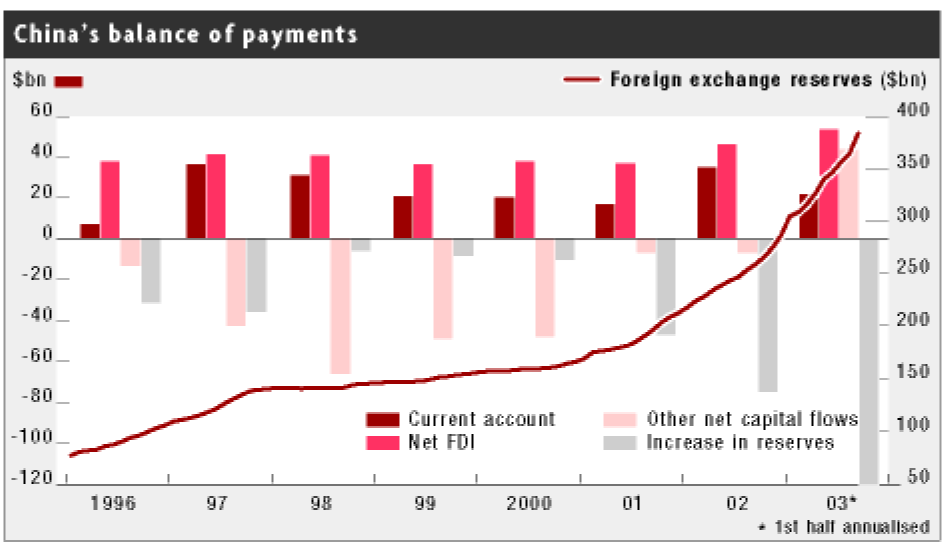


More important, the disadvantages of allowing the currency to appreciate are significant. It would represent a concession to pressure from the US authorities and speculators; it would lower domestic prices of tradeable goods in a country that already has very low inflation, with particularly severe effects on farmers; and it might reveal substantial weaknesses in the balance sheets of Chinese businesses.

It is also unclear what the right alternative regime would be. If the currency were repegged at a higher rate, speculators might well try again. If it were floated, it might overshoot. In the presence of exchange controls, it would also be difficult for companies to hedge foreign currency risk. But lifting exchange controls would expose bankrupt and ill-managed financial institutions to the temptations of the global capital markets.

All these seem cogent reasons not to consider changing policy. But there is also a reason to do so: the monetary consequences of current reserve accumulation. Money and credit have been growing far faster than nominal GDP this year. That means excessive investment now and still more non-performing loans in the years to come. Yet even this is not an overwhelming worry, at present. That is partly because the authorities believe they are bringing credit growth under control, partly because the government welcomes the high growth and partly because inflation is non-existent. Somewhat higher inflation could even be a helpful way to lower the mountain of bad debt in the financial system.

The conclusion is that the authorities will not change policy soon. In the short term, the aim, instead, will be to lower the pressure. Policies can - indeed, already do - include further liberalisation of capital outflow and imports, along with special programmes to buy goods abroad. All this makes practical sense.



In the medium term, the best and most likely policy would be a move to a heavily managed float, rather than an upward adjustment of the peg. Such a float is even compatible with exchange controls, as the

Indian example has shown. The float can be achieved by widening the bands or moving to an unspecified currency basket. The important feature of such a system would be greater exchange rate uncertainty. The authorities could increase that uncertainty by driving the dollar back up against the renminbi from time to time.

In the long term, however, China will want full liberalisation of exchange controls, a freely floating currency and an inflation-targeting central bank. But this would also require an efficient and well-regulated financial system. A good guess is that this will not happen before the beginning of the next decade, or even later.

Managing the transition of the renminbi to its prospective role as a world currency is a huge challenge. Large changes in policy cannot be expected right now. But the Chinese authorities should be liberalising imports and capital outflow aggressively, while moving, in the reasonably near future, to a more flexible exchange rate. The sooner the Chinese escape from their reserve-accumulation treadmill, the better off both they - and the world payments system - will be.

Sources for charts: IMF; Chinese government; Goldman Sachs; Thomson Datastream

** IMF Concludes 2003 Article IV Consultation with the People's Republic of China, November 18 2003, www.imf.org .*

martin.wolf@ft.com

Related stories
Fighting blind in Iraq Dec 02 2003 20:29
London's route to better transport Dec 02 2003 20:16
John Kay: A blessing in disguise? Dec 02 2003 19:22

= requires subscription to FT.com

Find this article at:
http://news.ft.com/s01/servlet/ContentServer?pagename=FT.com/StoryFT/FullStory&c=StoryFT&cid=1069493666987&p=1012571727126

☐ Check the box to include the list of links referenced in the article.